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Can the prepaid tuition program recover?

*Column by John Norris
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Q: I have read recently the Alabama Prepaid Affordable College Tuition (PACT) fund is in trouble. What happened, and can it be fixed?

A: The basic investment idea behind the PACT is simple. A family pays into the fund, and the invested assets grow faster than projected tuition payouts. Further, if more people buy into the fund than receive benefits, the fund runs a surplus. In so many ways, it operates like an insurance company.

According to the Treasurer's Office Web site, the PACT assumes an investment return of roughly 8 percent per year. Historically, this is attainable over time with a relatively modest allocation of 40-60 percent stocks.

As such, it is important to note the Treasurer's Office is assuming a reasonable rate of return. It is *not* expecting 15-20 percent or something crazy like that. Unfortunately, we have not had normal market conditions recently.

Since the end of 2007 through March 3, 2009, the S&P 500, a popular U.S. stock index, posted a minus-51.2 percent rate of return. As such, a fund with 50 percent invested in stocks would be in the red about 25 percent from the start. Bonds and other fixed income securities have only returned about 5 percent or so over that same time frame. As such, some quick math shows a portfolio invested 50 percent in stocks and 50 percent in bonds would have returned about minus-22.5 percent over the past 14 months.

Obviously, this is a hypothetical return. I don't know how the PACT actually performed. What does a minus-22.5 percent do to your return assumptions? It turns them absolutely upside down.

I did a very simple spreadsheet which suggests the PACT will have to return roughly 15 percent for the next five years or so in order to "catch up" to its 8 percent return assumption. This is difficult, if not impossible, under ordinary circumstances, let alone currently.

The PACT is also maturing. When it started, the PACT had more money coming into it than it had to spend on tuition. Today, the PACT probably shouldn't count on new contributions completely offsetting distributions moving forward. That is a fancy way of saying the money isn't coming in quite as fast as it once was, but it is still going out at the same rate or faster.

Compounding this is the simple fact 2008 was a horrible year for the economy, as well as the markets. When times are tight, and people are worried about their jobs, they probably aren't going to sign up for a college tuition savings program. Any money left over at the end of the month is going straight into the bank for a rainy day. To that end, the PACT saw virtually no growth in new participants/contracts last year.

It was the worst of all worlds, and, I am not sure the treasurer's office could have done anything significantly different, given its business model and reason for existence.

Can it be fixed? Sure, this is one of those problems that time and money can fix. First, if history serves as a guide, and it doesn't always, the PACT will eventually make up last year's dismal investment returns. Unfortunately, while we know this will take some time, we just don't know how much time it will take.

Second, it will take some money. Specifically, the PACT needs to plug the hole in the bottom of the bucket by attracting new contract holders, obtaining emergency grants, or keeping current contract

holders.

If this all happens, there is no reason why we won't be discussing the PACT in another 50 years.

John Norris is managing director of wealth management at Oakworth Capital Bank. He may be contacted via e-mail at John.Norris@OakworthCapital.com.
